ST 00-15
Tax Type: Sales Tax
Issue: Machinery & Equipment Exemption – Manufacturing

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 98-ST-**
	IBT
	Tax period: 1/1/95 —12/31/96
v.	
CARD Marketing Corp., Taxpayer	**Charles E. McClellan Administrative Law Judge**

ORDER ON TAXPAYER'S MOTION FOR PARTIAL SUMMARY JUDGMENT AND SETTING STATUS CONFERENCE

This matter comes on for decision on a motion for partial summary judgment filed by CARD Marketing Corp. ("taxpayer" or "CMC"). The motion has been fully briefed by both parties and oral argument has been heard.

Taxpayer's Motion:

Taxpayer's motion asks that it be awarded summary judgment on the issue of whether its manufacturing equipment located at its plant in SOMEWHERE, Illinois is exempt under Section 105/3-5(18) of the Use Tax Act and Section 120/2-5(14) of the Retailers' Occupation Tax.[1] The equipment in issue is used to manufacture display racks[2] that taxpayer provides to retailers to display the taxpayer's greeting cards and envelopes that the mass channel retailers are offering for sale.

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[1] Unless otherwise noted, all statutory references are to 35 ILCS 105/1, *et seq*., the Illinois Use Tax Act. (UTA) or to 35 ILCS 120/1, et *seq*., the Retailers' Occupation Tax Act (ROTA). The two statutes are complementary and the exemption language at issue in this case is the same in both statutes. Although the taxpayer's motion asks for relief under the ROTA, as well as the UTA, the ROTA is not involved in the issue raised by the motion because the issue relates to the use of the equipment not to the sale by which it was acquired. Therefore, the motion will be decided with reference to the UTA. However, if assets are exempt under the UTA, their purchase would also be exempt under the ROTA.

[2] Throughout the exhibits the term "fixtures" appears. The context of the documents indicates that it is meant to include the display racks manufactured at taxpayer's SOMEWHERE plant.

Undisputed Facts:

1. Taxpayer is a wholly owned subsidiary of CARD Cards, Inc., headquartered in SOMEWHERE, Missouri. Taxpayer Memo p. 2.[3]

2. Taxpayer is the selling arm for the greeting cards and other related personal communication goods, such as stationary and wrapping paper, manufactured by CARD Cards, Inc. *Id.*

3. Taxpayer also manufactures and assembles the display racks used by retailers for CARD merchandise in a 314,000 square foot plant in SOMEWHERE, Illinois. *Id*.

4. Taxpayer assembles the display fixtures used by CARD retailers to display merchandise in a number of states. These are the multi-tiered stands that allow customers to view and easily remove the greeting cards and envelopes for inspection and purchase. *Id.*

5. The fixtures are typically made in eight-foot sections, the manufacturing cost of which is about $4,000 per section. *Id.*

6. Some small retailers use a single eight-foot rack, while the largest displays range up to 280 linear feet, consisting of as many as 45 sections with a cost of as much as $180,000. *Id.*

7. Taxpayer distributes its products through two types of retailers. The first are specialty retail shops. These are the "CARD" shops commonly found in shopping centers. Their merchandise is limited to cards, gifts and the like. The second type of marketing consists of the mass channel retailers like Wal-Mart, Jewel and Walgreen. *Id.*

[3] “Taxpayer Memo” refers to the Memorandum in Support of Taxpayer’s Motion for Summary Judgment, which the taxpayer filed with its motion for partial summary judgment on July 15, 1999.

8. From the opening of the SOMEWHERE facility until 1994, more than half of the display racks made in SOMEWHERE were sold to CARD specialty stores, so there was no issue as to whether the plant was involved primarily in the manufacture of tangible personal property for sale or lease because more than 50% of the output was sold to the specialty shops. Taxpayer Memo p. 3.

9. Beginning in 1995, more than 50% of the display racks manufactured were used in the mass channel retail stores, such as Wal-Mart, Jewel and Walgreen's. These stores do not purchase the racks and taxpayer retains some ownership interest in the racks.

10. Until the 1980s, taxpayer simply gave the display fixtures to the mass channel retailers. The economies of scale in selling greeting cards to mass channel retailers made this transfer possible. Taxpayer Memo p. 4.

11. In the 1980s taxpayer found that competing greeting card manufacturers were using taxpayer's display racks once the mass channel retailers terminated their agreements with taxpayer, thus giving them a competitive cost advantage. *Id*.

12. In response, taxpayer restructured its marketing agreements. The new form of marketing agreement, "EXPRESSIONS FROM CARD MARKETING AGREEMENT", between taxpayer and the mass channel retailers, provides that "CMC shall loan fixtures to Retailer for the display of Products, pursuant to the terms of CMC's standard fixture loan agreement (Attachment D)." Taxpayer Memo p. 4, Exhibit B.[4]

13. A mass channel retailer's locations covered by a marketing agreement are listed in an attachment to the marketing agreement. Exhibit B, Attachment A.

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[4] Exhibit B is a copy of the marketing agreement entitled "Expressions from CARD Marketing Agreement." There are 5 attachments to the agreement lettered Attachment A through Attachment E that are integral parts of the marketing agreement.

14. The taxpayer’s products that are included in the marketing agreement and the products that are excluded from the marketing agreement are listed in an attachment to the marketing agreement. Exhibit B, Attachment B.

15. The terms of sale under the marketing agreement (including transportation charges, returns, product sales terms, payment terms and seasonal merchandise) are specified in an attachment to the marketing agreement entitled, “EXPRESSIONS FROM CARD TERMS OF SALE”. This attachment also contains a paragraph, regarding fixtures, that provides, “Display equipment and supplies may be loaned at no charge to qualifying Expressions From CARD accounts pursuant to the terms and conditions contained in the CMC Fixture Terms Acknowledgment.” Exhibit B, Attachment C.

16. The terms and conditions that apply to all fixtures provided to the mass channel retailer by the taxpayer are set forth in an attachment entitled, “CARD MARKETING CORPORATION FIXTURE TERMS ACKNOWLEDGEMENT”. Exhibit B, Attachment D.

17. An attachment entitled, “EXPRESSIONS FROM CARD DEPARTMENT CRITERIA”, sets forth the product display requirements the mass channel retailers must follow. Exhibit B, Attachment E.

18. The Department of Revenue conducted an audit for the period of January 1, 1995, through December 31, 1996. It concluded that during this period, taxpayer's purchases of manufacturing machinery and equipment did not qualify for the manufacturing machinery and equipment exemption because less than 50% of the fixtures were sold. About 55% of the display fixtures produced during the audit period were

transferred to the large mass channel retailers pursuant to the marketing agreements. (Taxpayer’s Memo, Affidavit of JOHN DOE at ¶ 14).

The Issue:

There are two issues to be addressed. The first issue relates to the characterization of the marketing agreement as a lease of the display racks or some other type of arrangement. If the marketing agreement is a lease, the equipment in the SOMEWHERE plant used to manufacture them qualifies under Section 105/3-5(18) for the machinery and equipment exemption as manufacturing equipment used primarily in the process of manufacturing or assembling tangible personal property for sale or lease.

The second issue is whether the characterization of the marketing agreement as a lease or as some other type of instrument should be determined under laws of Missouri or the laws of Illinois. The Department maintains that Missouri law controls. Taxpayer disagrees, arguing that the issue should be decided under Illinois law. As indicated below, I have determined that the result is the same, whether decided under Missouri law or Illinois law.

Conclusion:

“A plaintiff may move . . . for a summary judgment in his or her favor for all or any part of the relief sought” 735 ILCS 5/2-1005(a); and, “if a party moves for a summary determination of one or more, but less than all, of the major issues in the case, and the court finds that there is no genuine issue of material fact as to that issue or issues, the court shall thereupon draw an order specifying the major issue or issues that appear without substantial controversy, and directing such further proceedings upon the remaining undetermined issues as are just." 735 ILCS 5/2-1005(d).

In this case, taxpayer supported its motion for summary judgment with an affidavit and six documents, consisting of its marketing agreement and five standard forms of attachments thereto. The Department does not dispute any of the facts alleged in the taxpayer's motion and it agrees that there are no material issues of fact to be decided. Therefore, partial summary judgment on the issue presented is appropriate.

The statutory exemption in the UTA that is involved in this case provides as follows:

> (18) Manufacturing and assembling machinery and equipment used primarily in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease, whether that sale or lease is made directly by the manufacturer or by some other person, whether the materials used in the process are owned by the manufacturer or some other person, or whether that sale or lease is made apart from or as an incident to the seller's engaging in the service occupation of producing machines, tools, dies, jigs, patterns, gauges, or other similar items of no commercial value on special order for a particular purchaser.
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> 35 ILCS 105/3-5(18).
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> The applicable regulation provides:
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> e) Product Use.
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> 1) The statute requires that the product produced as a result of the manufacturing or assembling process be tangible personal property for sale or lease. Accordingly, a manufacturer or assembler who uses any significant portion of the output of his machinery or equipment, either for internal consumption or any other nonexempt use, or a lessor who leases otherwise exempt machinery and equipment to such a manufacturer or assembler, will not be eligible to claim the exemption on that machinery and equipment. No apportionment of production capacity between output for sale or lease and output for self-use will be permitted and no partial exemption for any item of machinery and equipment will be allowed.
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> 2) The production of articles of tangible personal property for sale, a portion of which is diverted by the manufacturer thereof to use as sales samples or as the subjects of quality control testing which renders the articles unfit for sale, will nevertheless be deemed to be production for sale,

> provided such diversion represents only a small portion of the production of the articles of tangible personal property or of the sale of those articles.
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> 3) Machinery and equipment used in the performance of a service, such as dry cleaning, is not used in the production of tangible personal property for sale and is thus taxable. However, a manufacturer or assembler who uses machinery and equipment to produce goods for sale or lease by himself or another, or to perform assembly or fabricating work for a customer who retains the manufacturer or assembler only for his services, will not be liable for tax on the machinery and equipment he uses as long as the goods produced either for himself or another are destined for sale or lease, rather than for use and consumption.
> 86 Ill. Admin. Code § 100.330

Generally, statutes imposing taxes are strictly construed in favor of the taxpayer and against the state so that the taxpayer is not deprived of his property by summary proceeding or by penalties or forfeitures. United Legal Foundation v. Department of Revenue, 272 Ill. App. 3d 666, 650 N.E. 2d 1064 (1st Dist. 1995). However, a statute which exempts property or an entity from taxation must be strictly construed in favor of taxation and against exemption, and the exemption claimant must prove clearly and conclusively its entitlement. Wyndemere Retirement Community v. Department of Revenue, Ill. App. 3d, 455, 459 (1995). Additionally, in analyzing an exemption, all facts are to be construed and all debatable questions resolved in favor of taxation. *Id.* In this case, the taxpayer is seeking to take advantage of a statutory exemption, so the statute must be construed and debatable questions resolved in favor of the Department.

Addressing the issues in reversed order, the first issue is whether the nature of the marketing agreement should be determined under Missouri law or Illinois law. The definition of the term "lease" is identical in the statutes of both states. The language defining the term "lease", was taken from the Uniform Commercial Code and adopted by both states. It reads as follows:

> "'Lease' means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease. Unless the context clearly indicates otherwise, the term includes a sublease agreement." 810 ILCS § 5/2A-103(j); Mo. Rev. Stat. §400.2A-309(1)(j).

The marketing agreement contains a provision that requires the agreement to be construed in accordance with the laws of Missouri, and the Department, in its brief, assumes that Missouri law should control. The taxpayer disagrees, but cites legal authority from the courts of Missouri and other states in support of its position on the characterization of the marketing agreement. Neither party provided any analysis, argument, or legal authority in support of its position regarding the issue of which state's laws determine the character of the marketing agreement.

The marketing agreement is a contract between the taxpayer and a mass channel retailer. Significantly, the factors underlying the issue in this case are more closely related to Illinois than to Missouri. The issue is whether taxpayer's equipment located in SOMEWHERE, Illinois, qualifies for the manufacturing equipment exemption under the Illinois Use Tax Act. This case does not involve a contractual dispute between the parties requiring the construction of a contractual provision. Also, the Department is not a party to the marketing agreement, so the contractual provision mandating construction under Missouri law is not binding on the Department of Revenue. Therefore, I conclude that the issue in this case regarding the exemption should be determined under Illinois law. However, after reviewing applicable Missouri case law, I conclude that the result in this case would be the same under the laws of either state.

The second issue is whether taxpayer's marketing agreement is a lease or some other arrangement. Taxpayer argues that the marketing agreement has all of the elements of a lease under Missouri law. Taxpayer's Memorandum p. 9. Taxpayer relies on a number of cases to support its assertion that the marketing agreement is a lease. It cites Sharp v. W. &W. Trucking Company, 421 S.W.2d 213 (S.Ct. 1967) for the proposition that a "distinctive feature of a lease of property, real or personal, is that it conveys an interest in the property for a fixed or definite period of time and is supported by a consideration." That proposition is not in dispute. Taxpayer cites Friend v. GEM International, 476 S.W.2d 134 (S.Ct. 1971) for its listing of the elements of a lease as being: "1) a reversion in the landlord, 2) the creation of an estate in the tenant, either at will or for a term less than that for which the landlord hold, 3) the transfer of exclusive possession and control of the premises to the tenant, and 4) a contract, either express or implied, between the parties." Friend, 476 S.W.2d at 138. (St. Louis Ct. App. 1972). Taxpayer Memorandum p. 8. It cites Delay v. Douglas, 164 S.W.2d 154 (Mo. Ct. App. 1942) for the proposition that no particular words are necessary to create a lease, and Friend, supra, for the proposition that, "the nature of the relationship depends on how it fits within the standards set by law." Taxpayer Memorandum p. 9. None of these cases involve a situation like this one in which the agreement describes the transaction as a "loan" and contains language renouncing consideration for the use of the subject property. These cases do set forth the general requirements for a valid lease under Missouri law, however, and, as shown by the cases cited below, the requirements under Illinois law are substantially the same.

Taxpayer also states that, "[T]he Department has suggested that CMC is 'loaning' the display racks to the retailers." Taxpayer Memorandum p. 10. This is incorrect, as the Department did not characterize the transaction as a loan. Rather, taxpayer's marketing agreement and attachments repeatedly referred to it as a loan. Taxpayer goes on to state that, "In order for a transfer of property to be a gratuitous loan or bailment, as opposed to a lease, the property must be used by a bailee without reward and may be retaken by the bailor at any time", citing Slack v. Bryan, 184 S.W.2d 873 (Ky. Ct. App. 1945). The taxpayer then cites Bailey v. Innovative Management & Investment, Inc., 916 S.W.2d 805 (S. Ct. Mo. 1967) for the proposition that, "A gratuitous bailment is created for the exclusive benefit of the bailee and results when property is loaned to another simply for his or her own use without reward or compensation being provided to the bailor."

The Department argues that the marketing agreement is not a lease because it does not have a definite term measured in time. Department's Response p. 3. The Department also argues that, "the consideration for the agreement flows almost exclusively from the taxpayer to the mass channel retailer." *Id.*

Black's Law Dictionary defines the word "lease", when used in connection with personal property, as follows:

> When used with reference to tangible personal property, [the] word "lease" means a contract by which one owning such property grants to another the right to possess, use and enjoy it for specified period of time in exchange for periodic payment of a stipulated price, referred to as rent. (Citing Undercofler v. Whiteway Neon Ad, Inc., 114 Ga.App. 644, 152 S.E.2d 616, 618) Black's Law Dictionary, 800 (5th ed. 1979)

"In Illinois, four elements are required to create a valid lease: (1) a definite agreement as to the extent and bounds of the property leased; (2) a definite and agreed term; (3) a definite agreement as to the rental; and (4) the time and manner of payment." Chapman v. Brokaw, 225 Ill.App.3d 662, 665 588 N.E.2d 462, 465 (3rd Dist. 1992); Ricke v. Ricke, 83 Ill.App.3d 1115, 1119, 405 N.E.2d 351, 356 (2nd Dist. 1980). Metropolitan Airport Authority of Rock Island County v. Property Tax Appeal Board, 307 Ill.App.3d 52, 716 N.E.2d 842 (3rd Dist. 1999) A key element of a valid lease is a provision specifying the time and manner of rent payment. American National Bank v. Powell, 293 Ill.App.3d 1033, 691 N.E.2d 1162 (1st Dist. 1998) A lease that does not describe the term as a specific time period can define it by reference to collateral events. Ricke v. Ricke, 83 Ill.App.3d at1120.

In this case, the marketing agreement, at paragraph 2, provides that the time period covered by the agreement starts on the date that the CARD department has been installed in all of the mass channel retailer's stores covered by the agreement. It ends when the net wholesale shipments of CARD products to the mass channel retailer for the stores covered by the agreement reach a specified dollar amount termed the "volume quota". These are collateral events that define the term of the agreement, so the agreement satisfies the requirement that the document must have "a definite and agreed term".

The marketing agreement does not, however, satisfy the requirement of having a definite agreement as to the rental and the time and manner of payment. The monetary consideration that flows from the mass channel retailer to the taxpayer is derived solely from the sale of taxpayer's products by the mass channel retailer.

If the language of a contract is clear and explicit a court must determine the intent of the parties solely from the document itself. USG Interiors, Inc. v. Commercial and Architectural Products, Inc., 241 Ill.App.3d 944, 609 N.Ee.2d 811 (1st Dist. 1993) In this case, until the 1980s, taxpayer simply gave the display fixtures to the mass channel retailers. The economies of scale in selling greeting cards to mass channel retailers made this transfer possible. In the 1980s taxpayer found that competing greeting card manufacturers were using taxpayer's display racks once the mass channel retailers terminated their agreements with taxpayer, thus giving the competitors a competitive cost advantage. To solve this problem, taxpayer restructured its marketing agreements.

There is no language anywhere in the marketing agreement that provides for or suggests monetary consideration to be paid to the taxpayer by the mass channel retailer for the use of the fixtures. The new form of marketing agreement, "EXPRESSIONS FROM CARD MARKETING AGREEMENT", between taxpayer and the mass channel retailers provides that "CMC shall loan fixtures to Retailer for the display of Products, pursuant to the terms of CMC's standard fixture loan agreement (Attachment D)." Taxpayer Exhibit B, p. 2. Attachment C specifically states that the fixtures are loaned by the taxpayer to the mass channel retailer at no cost to the mass channel retailer.

As the taxpayer asserts, there is a benefit to both the taxpayer and the mass channel retailer from the loan of the fixtures. The taxpayer's products are displayed in the manner in which it wants them displayed, competitors are prevented from using its taxpayer's fixtures, and the mass channel retailer has the use of the fixtures at no cost. If taxpayer were not loaning the fixtures to the mass channel retailer, the mass channel retailer would have to purchase them either from the taxpayer or from another source. Thus, the agreement provides mutual benefits. These benefits are not forms of consideration set forth in the marketing agreement, however. They are incidental benefits. The language in the documents, consistently and repeatedly referring to the transfer of the fixtures as a loan at no cost to the mass channel retailer, indicates that the taxpayer never intended to be compensated by the retailer for the use of the display racks. Therefore, the marketing agreement fails to satisfy all of the requirements of a lessor-lessee relationship.

The arrangement has all of the elements of a bailment, however. A bailment has been defined as "the delivery of goods for some purpose, upon a contract, express or implied, that after the purpose has been fulfilled they shall be redelivered to the bailor, or otherwise dealt with according to his directions, or kept till he reclaims them." Kirby v. Chicago City Bank and Trust Company, 82 Ill.App.3d 1113, 403 N.E.2d 720 (1st Dist. 1980), quoting Knapp, Stout & Co. v. McCaffrey, 178 Ill. 107, 52 N.E. 898 (1899), aff'd 177 U.S. 638, 20 S.Ct. 824 (1900). Accord, Hope v. Costello *et al.*, 222 Mo.App.187, 297, 297 S.W. 100 (Mo. Ct. App. 1927) App. 1927), Nuell v. Forty-Ninth Corp., 358 S.W.2d 70 (Mo. Ct. App. 1962). The agreement between taxpayer and the mass channel retailer regarding the loan of the fixtures, as embodied in the marketing agreement and Attachments C and D, is squarely within this definition.

As noted, the marketing agreement provides that CMC, "shall loan fixtures" to the retailer. Attachment C to the marketing agreement states that "Display equipment and supplies may be loaned at no charge to [retailers] pursuant to the terms and conditions contained in the CMC Fixture Terms Acknowledgment." Attachment D is the fixture terms acknowledgment document. It requires the mass channel retailer's authorized signature and sets forth the conditions that apply to the mass channel retailer's use of the display racks and fixtures. By signing the acknowledgment document, the mass channel retailer agrees to the following conditions that make it a bailment:

1. The fixtures are being loaned by CMC to the mass channel retailer for the stated purpose of using them solely for the display of merchandise or products purchased from CMC.
2. They are being loaned as part of the marketing agreement which is a contract.
3. At the termination of the agreement they must be returned to CMC or disposed of according to directions from CMC.
4. The agreement may be terminated at any time for any reason by either party on 60 days notice, and, under certain circumstances, by CMC on 24 hours notice.

As stated previously, because the taxpayer is seeking an exemption in this case, the law requires that I construe all facts and resolve all debatable questions in favor of taxation. On that basis, I have concluded that the arrangement between the taxpayer and the mass channel retailers regarding the fixtures is not a lease. Therefore, the manufacturing equipment at the SOMEWHERE, Illinois plant used to manufacture them is not qualified for the exemption provided in Section 105/3-5(18) of the Use Tax Act.

For these reasons, taxpayer's motion is denied and this matter is set for status on June 7, 2000 at 9:00 a.m., without further notice to the parties.

ENTER: May 3, 2000

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Administrative Law Judge